UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 96-10320

In The Matter of:
SOUTHMARK CORPORATION,

Debtor.

SOUTHMARK CORPORATION,

Appellant,

versus

COOPERS & LYBRAND;
THOMPSON & KNIGHT,

Appellees.

Appeal from the United States District Court
for the Northern District of Texas

[FILED Jan. 11, 1999]

Before JOLLY, JONES, and PARKER, Circuit Judges.

EDITH H. JONES, Circuit Judge:

This appeal arises from a malpractice suit filed by Southmark Corporation ("Southmark") against Coopers & Lybrand L.L.P. ("Coopers"), the

accountant to the court-appointed Examiner in Southmark's reorganization case under Chapter 11 of the Bankruptcy Code. Southmark filed suit in a Texas state court in April, 1995. Coopers removed the case to the bankruptcy court that had presided over Southmark's reorganization. In an unusual twist, Southmark did not perceive the bankruptcy court as a beneficial forum, so it moved for the court's mandatory abstention, or alternatively, for discretionary abstention or remand. 11 U.S.C. §§ 1334(c) (1984). Coopers sought summary judgment, a motion the bankruptcy court granted while denying Southmark's challenges to the forum. On appeal, the district court affirmed. We hold that the state-law malpractice claim is a "core proceeding" in bankruptcy and that the bankruptcy court's earlier ruling requiring Coopers to disgorge part of its fees for breach of bankruptcy disclosure rules gives rise to issue preclusion but not necessarily to claim preclusion.

I. BACKGROUND

Southmark Corporation was a real estate investment trust that sponsored private and publicly syndicated real estate partnerships during the early 1980's. From 1982 until 1989 (shortly before Southmark declared bankruptcy), Drexel Burnham Lambert, Inc. ("Drexel") served as Southmark's primary investment banker, underwriter, securities broker and investment and financial advisor. Drexel was the underwriter for various Southmark offerings of junk bonds and preferred stock, totaling more than $1 billion.

During this period, Drexel was ostensibly underwriting high-yield bond issues for companies with the understanding that the companies would use the proceeds to purchase high-yield bonds from

other Drexel clients. Southmark became involved in the Drexel scheme. In October, 1986, Southmark issued $400 million in junk bonds and $100 million in preferred stock and subsequently invested the bond proceeds and part of the preferred stock revenues in other junk bond securities.

As with many speculative ventures in the 1980's, the expanding balloon eventually burst. In April 1989, Southmark announced a $1 billion write-down of its asset values, wiping out shareholders' equity. A few months later, Southmark filed for Chapter 11 bankruptcy protection. Eventually, the holders of Southmark's public debt received approximately 5 cents on the dollar in cash and securities in the reorganized Southmark that were projected at the time to be worth as much as 13 cents on the dollar.

Shortly after filing bankruptcy, Southmark requested the appointment of an Examiner to provide an unbiased, independent assessment of the propriety and practicality of pursuing litigation against third-parties. The court-appointed Examiner applied to the bankruptcy court to retain Coopers as the Examiner's accountant. Coopers was expressly directed by the court to investigate, among other things, Drexel's dealings with Southmark. Coopers disclosed at the time of its retention that it did some accounting work for Drexel, but the firm failed to disclose either the kind and degree of work it did for Drexel, or that Coopers did substantial auditing work for Drexel.

Drexel's parent company, reeling from reverses in the junk-bond market, filed bankruptcy in February 1990. Southmark alleges that Coopers did not satisfactorily investigate Drexel's exposure to claims based upon Southmark's ill-fated junk bond investments. A Coopers employee charged that he

was removed from this aspect of the Southmark account when he recommended investigating claims against Drexel to his superiors and was ordered to desist because (unbeknownst to Southmark) Drexel was one of Coopers' largest accounting clients. In the end, Coopers submitted a report to Southmark that downplayed the viability of these particular claims against Drexel. Southmark elected not to pursue these claims by filing a timely proof of claim in the Drexel bankruptcy case.

Instead, Southmark focused its limited resources on seeking recovery against Michael Milken, the mastermind behind Drexel's junk bond operation, who, unlike Drexel, had not filed bankruptcy. Southmark developed claims against Milken that it asserts are identical to the claims it could have raised against Drexel if Coopers had completed its investigation. Southmark eventually reached a settlement agreement that could yield more than $20 million from the Milken settlement fund.

II. PROCEDURAL HISTORY

In April 1993, Galbally, then a Coopers employee, met with Southmark's general counsel and alleged that Coopers had thwarted his efforts to investigate the Drexel claims. Southmark thereupon filed a disgorgement motion in the bankruptcy court pursuant to FED. R. CIV. P. 60(b) and Bankruptcy Rule 9024, seeking reconsideration of the court's previous award of fees to Coopers for its work as the Southmark Examiner's accountant. After extensive discovery, briefing, and a hearing, the bankruptcy court awarded Southmark $585,042.48 in recovery from Coopers in a modified final order entered April 4, 1995.

Three days later, Southmark commenced the instant case in a Texas state court, alleging that Coopers held back from a full investigation of certain potential claims by Southmark against Drexel; failed to disclose this omission; and misrepresented its investigative efforts because Drexel was a large audit client of Coopers. Additionally, Southmark alleged that Coopers' failure to investigate deterred Southmark from pursuing potential claims against Drexel or filing a proof of claim in the Drexel bankruptcy. Southmark's state law causes of action for breach of contract, fraud, breach of fiduciary duty and negligent misrepresentation alleged that Coopers' conduct caused it to suffer damages, including the total fees it paid Coopers during its bankruptcy case and the amounts it would have recovered on timely claims against Drexel.

Coopers answered the state court petition and then removed the case to the federal district court, which referred the action to the same bankruptcy court that had conducted Southmark's bankruptcy and the disgorgement proceeding.[1] Southmark filed a motion for mandatory abstention, or, in the alternative discretionary abstention or remand based in part on the argument that the state law action was a non-core proceeding and therefore, abstention was required under 28 U.S.C. § 1334(c)(2). Coopers moved for summary judgment. The bankruptcy court granted Coopers' motion and dismissed the action as barred by both collateral estoppel and res judicata; the court denied Southmark's abstention

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[1] Along the way, Coopers joined Southmark's former general counsel as a third-party defendant.

motion as moot without expressly addressing its merits.

On appeal by Southmark, the district court affirmed. Announcing its reasoning in open court, the district court found that Southmark's action presented a core proceeding and that the bankruptcy court had implicitly so found in its earlier order, and he affirmed the bankruptcy court's findings regarding preclusion. Southmark has appealed.

III. ANALYSIS

No factual findings of the bankruptcy court are contested on appeal. The conclusions of law of both the bankruptcy and district court are subject to *de novo* review. *Criswell v. Hensley*, 102 F.3d 1411, 1414 (5th Cir. 1997)

A. Southmark's Motion to Abstain

Lurking like a troll beneath a bridge, procedural complexities bedevil a straight path to analysis of this case. That the bankruptcy court has some kind of jurisdiction over this malpractice action against court-appointed professionals is not in doubt. But what the court can do with its jurisdiction depends first on whether the malpractice case is a "core" bankruptcy matter or one that is "related to" Southmark's reorganization case. If the suit against Coopers is merely "related to" bankruptcy, the bankruptcy court was required to abstain from hearing it. 28 U.S.C. § 1334(c)(2).[2] If, however,

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[2] The parties do not dispute that additional statutory criteria for mandatory abstention are met here. Those criteria include a state-law cause of action, no other basis for federal court jurisdiction, and the pendency of

the controversy lies "at the core of the federal bankruptcy power," *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71, 102 S. Ct. 2858, 2870-71 (1982), the bankruptcy law permits but does not require abstention. 28 U.S.C. § 1334(c)(1).[3] The root issue is as simple -- and complex -- as that.

Three procedural obstacles must be cleared before the merits discussion can proceed. First, although this court may review the bankruptcy court's decision not to abstain, our jurisdiction is an historical anomaly. For bankruptcy cases commenced after the 1994 amendments to the bankruptcy law, decisions either to abstain or not to abstain are not, with very limited exceptions, reviewable on appeal.[4] Southmark's case predates this amendment and was filed when decisions not to abstain were reviewable on appeal.[5] The standard

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state court litigation that can timely adjudicate the claim. *See* 28 U.S.C. § 1334(c)(2).

[3] A court may discretionarily "abstain from hearing state law claims whenever appropriate 'in the interest of justice, or . . . comity with state courts or respect for State law.'" *Gober v. Terra + Corp.*, 100 F.3d 1195, 1206 (5th Cir. 1996) (quoting 28 U.S.C. § 1334(c)(1)).

[4] 28 U.S.C. § 1334(d) (1994). "Any decision to abstain or not to abstain made under this subsection (other than a decision not to abstain in a proceeding described in subsection (c)(2)) is not reviewable by appeal or otherwise by the court of appeals . . . or by the Supreme Court. . . .").

[5] 28 U.S.C. § 1334(c) (2), enacted in the Bankruptcy Amendments Act of 1984, Pub. L. 98-353, July 10, 1984, 98 Stat. 333. ("Any decision to abstain made

on appeal is abuse of discretion. *In re Howe*, 913 F.2d 1138, 1143 n.6 (5th Cir. 1990).

Second, we note, only to reject out of hand, Coopers' assertion that statutory abstention does not apply to cases removed to federal court on the basis of bankruptcy jurisdiction. 28 U.S.C. § 1452. There is no textual support in the statute for this position, only a handful of bankruptcy court opinions support it, and the vast majority of courts hold otherwise.[6] We endorse the majority rule.

Third, the bankruptcy court should have decided the jurisdiction/abstention issues before reaching the preclusion issues. *Marathon Oil Co. v. Ruhrgas*, 145 F.3d 211 (5th Cir. 1998) (*en banc*), *cert. granted*, 67 U.S.L.W. 3273 (U.S. Dec. 7, 1998) (No. 98-470). Its diffidence may understandably have been related to its uncertainty whether Southmark's claims invoke core or non-core jurisdiction. But no

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under this subsection is not reviewable by appeal or otherwise."). *See* 1 Collier on Bankruptcy (15th Ed.) § 3.01, at 3-74. By negative implication, as *Collier's* notes, decisions not to abstain are reviewable on appeal. *Id.*

[6] *See In Re United States Brass Corp.*, 173 B.R. 1000, 1004 (Bankr. E.D. Tex. 1994) ("it is the majority opinion that abstention does apply to [removed] cases . . ."); *see also Robinson v. Michigan Consol. Gas Co., Inc.*, 918 F.2d 579, 584 n.3 (6th Cir. 1990); *Williams v. Shell Oil Co.*, 169 B.R. 684, 690 (S.D. Cal. 1994). *But see In re Branded Products*, 154 B.R. 936 (Bankr. W.D. Tex. 1993) (mandatory abstention is inapplicable to cases removed from state courts pursuant to 28 U.S.C. § 1452).

pussy-footing around is allowed on jurisdictional issues.

All of that said, the question is how Southmark's claims fit into bankruptcy jurisdiction. The progenitor of the current bankruptcy system is another *Marathon* case,[7] in which the Supreme Court struck down as constitutionally too far-reaching Congress's assignment of jurisdiction to non-Article III bankruptcy judges under the 1978 Bankruptcy Code. In *Marathon*, the debtor filed suit on a pre-bankruptcy state-law breach of contract claim. Justice Brennan, writing for the plurality, distinguished between "the restructuring of debtor-credit relations, which is at the core of the federal bankruptcy power" and the "adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case." 458 U.S. at 71, 102 S. Ct. at 2871. The narrowest construction of *Marathon*, that placed upon it by Chief Justice Burger's dissenting opinion, is this:

> a "traditional" state common law action, not made subject to a federal rule of decision, and related only peripherally to an adjudication of bankruptcy under federal law, must, absent the consent of the litigants, be heard by an "Art. III court" if it is to be heard by any court or agency of the United States.

Id. at 92, 102 S. Ct. 2882 (Burger, C.J., dissenting).

Congress, re-enacting bankruptcy courts' jurisdiction in the wake of *Marathon*, drew on the

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[7] *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982).

"core" terminology to describe matters or proceedings that are an integral part of the bankruptcy case. For present purposes, such core jurisdiction statutorily includes "matters concerning the administration of the estate," 28 U.S.C. § 157(b)(2)(A) and "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor ... relationship...." *Id.* at § 157(b)(2)(O). The statute also permits bankruptcy courts to hear and determine other matters that are "related to" bankruptcy but are not "core" matters subject to the ultimate authority of the district court.[8]

In this circuit, Judge Wisdom authored a significant opinion interpreting both *Marathon* and the post-*Marathon* jurisdictional amendments. *See In re Wood*, 825 F.2d 90 (5th Cir. 1987). *Wood* involved a lawsuit filed by a third-party against the debtor over shares of stock acquired by the debtor post-petition. Judge Wisdom distilled the formula for bankruptcy court jurisdiction thus:

> We hold, therefore, that a proceeding is core under section 157 if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case. The proceeding before us does not meet this

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[8] "Related-to" matters are those which, being peripheral to the concerns of the bankruptcy case and based on extrinsic sources of law, require mandatory abstention. *See* discussion *supra* note 2. The bankruptcy court may make a recommendation to the district court on the disposition of related-to matters, but it may not enter judgment concerning them unless the parties expressly so consent. 28 U.S.C. § 157(c).

> test and, accordingly, is a non-core proceeding. The plaintiff's suit is not based on any right created by the federal bankruptcy law. It is based on state created rights. Moreover, this suit is not a proceeding that could arise only in the context of a bankruptcy. It is simply a state contract action that, had there been no bankruptcy, could have proceeded in state court.

Id. at 97 (footnote omitted).

Southmark contends that its claims against Coopers do not satisfy the Wood test for core bankruptcy jurisdiction. First, Southmark's claims arise under state, not federal law and involve the company's "private rights" against Coopers rather than a "restructuring of debtor-creditor relations." Second, Southmark contends, the action against Coopers is not "a proceeding that, by its nature, could arise only in the context of the bankruptcy case." *Id.*

Although Southmark is correct in focusing attention on *Marathon*, the post-*Marathon* jurisdictional provisions, and on *Wood*, its interpretation of core bankruptcy matters is too narrow. To begin with, the state law origin of Southmark's claims is not dispositive. The jurisdictional statute expressly provides that the applicability of state law to a proceeding is insufficient in itself to render it a non-core proceeding. 28 U.S.C. § 157(b)(3). This provision, as *Wood* explains, recognizes Justice White's sensible observation in *Marathon* that many truly bankruptcy issues, like the determination of the basis for creditors' claims, turn on state law. *Wood*, 825 F.2d at 96. That Southmark's claims against the

court-appointed accountant for its examiner arose under state law does not prevent them from involving core jurisdiction.

Southmark also disputes that its claims could arise "only in the context of a bankruptcy case," inasmuch as Southmark could have sued any accounting firm that worked for it on similar grounds of disloyalty, non-disclosure and malpractice. It is somewhat disingenuous for Southmark to attempt to pry these claims out of their bankruptcy setting. Southmark's petition alleges *inter alia* claims for breaches of fiduciary duty and of the contract whose terms were approved by the bankruptcy court. Southmark prays for actual damages including return of the entire $4 million fee it paid Coopers from money belonging to the debtor's estate. The fee award was both approved by the bankruptcy court and subjected to the bankruptcy court's later disgorgement order.

In this case, the professional malpractice claims alleged against Coopers are inseparable from the bankruptcy context. A *sine qua non* in restructuring the debtor-creditor relationship is the court's ability to police the fiduciaries, whether trustees or debtors-in-possession and other court-appointed professionals, who are responsible for managing the debtor's estate in the best interest of creditors. The bankruptcy court must be able to assure itself and the creditors who rely on the process that court-approved managers of the debtor's estate are performing their work, conscientiously and cost-effectively. Bankruptcy Code provisions describe the basis for compensation, appointment and removal of court-appointed professionals, their conflict-of-interest standards, and the duties they must perform. *See*

generally 11 U.S.C. §§ 321, 322, 324, 326-331. Although standards for the conduct of court-appointed professionals, the breach of which may constitute bankruptcy malpractice, are not comprehensively expressed in the statute, the Code need not duplicate relevant, also-applicable state law. It is evident that a court-appointed professional's dereliction of duty could transgress both explicit Code responsibilities and applicable professional malpractice standards. For instance, in *Billing v. Ravin, Greenberg & Zackin, PA.*, 22 F.3d 1242 (3d Cir. 1994), the professional malpractice allegations included the attorneys' failure to comply with court orders and to submit a plan of reorganization to the bankruptcy court. Award of the professionals' fees and enforcement of the appropriate standards of conduct are inseparably related functions of bankruptcy courts.

Supervising the court-appointed professionals also bears directly on the distribution of the debtor's estate. If the estate is not marshaled and liquidated or reorganized expeditiously, there will be far less money available to pay creditors' claims. Excessive professional fees or fees charged for mediocre or, worse, phantom work also cause the estate and the creditors to suffer. Southland might retort that this concern for the general well-being of the debtor's estate is over-played -- technically, the liquidation of any claim that the debtor holds against third parties would enhance the debtor's estate as much as collection on a malpractice claim against court-appointed professionals. *Marathon* held, in fact, that a debtor's contract claim against a third party (which had not filed a claim in bankruptcy) was not within the bankruptcy court jurisdiction, even though successful prosecution of the action would enrich the debtor's estate. And in *Wood*, a dispute

over shares of stock acquired by the debtor post-petition fell only within the related-to jurisdiction but not core bankruptcy jurisdiction. These cases are, however, distinguishable from a malpractice claim involving court-appointed professionals. In the *Marathon* and *Wood* situations, the claims that were being prosecuted could stand alone from the bankruptcy case. A malpractice claim like the present one inevitably involves the nature of the services performed for the debtor's estate and the fees awarded under superintendence of the bankruptcy court; it cannot stand alone.

Even more significant, the claim against Coopers is not just for malpractice, but for the value of the asset which Coopers was to assist Southmark in recovering. If Coopers had done the job for which it was retained, according to Southmark's allegations, Southmark would have filed a claim in the Drexel bankruptcy and recovered a substantial sum for creditors. The claim against Coopers may therefore be viewed as one to recover an asset of Southmark's estate that Coopers let slip away.

From yet another perspective, this is not just a malpractice case like any other professional malpractice litigation Southmark might pursue. Instead, Coopers has filed administrative claims to obtain its fees in the bankruptcy court, and the debtor's action is similar to a counterclaim against Coopers. Unlike essential parties in *Marathon* or *Wood*, Coopers is not a stranger to the bankruptcy case, and this malpractice claim may invoke the bankruptcy court's core jurisdiction to adjudicate and determine the extent of claims by and against Southmark's estate. *See* 28 U.S.C. § 157(2)(B); *see generally Billing*, 22 F.3d 1242.

Although surprisingly few court of appeals cases have explored the boundaries of bankruptcy courts' core jurisdiction in the wake of *Marathon*, at least three decisions are premised on the understanding that professional malpractice claims against court-appointed professionals are indeed core matters. *See Billing*, 22 F.3d 1242; *Walsh v. Northwestern Nat'l Ins. Co.*, 51 F.3d 1473, 1476 (9th Cir. 1995); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 483 n.4 (6th Cir. 1992). No appeals court decision has held otherwise. In one case against a bankruptcy trustee to recover property that did not belong to the debtors' estate, the court rejected subject matter jurisdiction founded on either core or related-to-bankruptcy jurisdiction. *In re Guild and Gallery Plus, Inc.*, 72 F.3d 1171, 1173 (3d Cir. 1996).

Southmark's lawsuit draws into question Coopers' performance of its duties under court order, and it seeks in part to recover on the claim Southmark would have had against Drexel. For these and other reasons just discussed, we conclude that Southmark's case against Coopers is a core proceeding in bankruptcy. Because this is a core proceeding, the bankruptcy court had discretion whether to abstain from hearing it. We hold that the court did not abuse his discretion in declining to abstain.

B. Preclusion Issues

Southmark has already recovered damages of a sort from Coopers, in that the bankruptcy court ordered Coopers to disgorge over $550,000 of the fees it received as court-appointed examiner. The recovery, based on Coopers' failure to disclose its professional relationships with Drexel pursuant to

11 U.S.C. § 328(c), consisted of Drexel-related fees of $55,000, together with treble that amount as a penalty, plus reimbursement of Southmark's costs and attorneys fees in prosecuting the motion. Coopers asserts that this recovery, which neither party appealed, provides a basis for either issue or claim preclusion against Southmark's current lawsuit. Preclusion rules deter repetitive and piecemeal litigation by preventing the relitigation of issues that have been finally decided and the assertion of claims covering transactions that have already been disputed in court. The criteria for issue and claim preclusion are different, however and one rule may apply when the other does not. While we doubt that a basis for claim preclusion existed here, issue preclusion prevents Southmark from relitigating the cause of its failure to file a timely proof of claim in the Drexel bankruptcy.

1. Issue Preclusion

Issue preclusion, formerly known as collateral estoppel, applies when the following elements are met:

> (1) the issue at stake must be identical to the one involved in the prior action; (2) the issue must have been actually litigated in the prior action; and (3) the determination of the issue in the prior action must have been a part of the judgment in that earlier action.

Recoveredge L.P. v. Pentecost, 44 F.3d 1284, 1290 (5th Cir. 1995). Relitigation of an issue is not precluded unless the facts and the legal standard used to assess them are the same in both

proceedings. *Id.* at 1291 (citations omitted)9 The bankruptcy court and the district court found that Southmark was bound by issue preclusion from asserting that Coopers' malpractice caused Southmark to suffer damages, as that issue had already been litigated and decided in the bankruptcy court disgorgement proceeding.

Southmark first argues that the relevant issues are not identical. The disgorgement proceeding only resolved whether Coopers' failure *to disclose a conflict of interest* caused Southmark to fail to file a claim against Drexel (the bankruptcy court concluded it did not). In the instant case, Southmark alleges that Coopers's failure to *adequately investigate* the viability of a claim against Drexel caused Southmark to fail to file a timely claim.

Coopers responds that the causation of damages issue is the same in the disgorgement proceeding and the instant case. We agree. It was undisputed that Coopers did not disclose to the bankruptcy court its significant auditing relationship with Drexel. In order to gauge the penalty for nondisclosure, the bankruptcy court had to assess whether Coopers' ethical conflict, reflected in nondisclosure of the relationship and inadequate investigation of Drexel claims, led Coopers to downplay potential Southmark claims against Drexel and to discourage Southmark from pursuing its rights against Drexel.

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9 Southmark cites a fourth, "special circumstance" requirement for application of issue preclusion. *See Copeland v. Merrill Lynch & Co. Inc.*, 47 F.3d 1415 (5th Cir. 1995). If such a requirement applies in this case, a proposition we find highly questionable, Southmark has in any event failed to support it factually. *See Recoveredge*, 44 F.3d at 1290-91 n.12.

Southmark asserts that the issues are different because "Coopers could have failed to disclose its conflict of interest to the Bankruptcy Court and still could have done its job properly." This distinction is theoretically possible but inconsistent with the way in which the disgorgement proceeding was litigated. Southmark wanted the bankruptcy court to find that Coopers' overall lapses caused Southmark to fail to file a timely proof of claim, a scenario that would enhance its argument for full disgorgement of Coopers' multimillion dollar court-approved fees.[10] In contrast, to minimize the impact of its actions, Coopers contended that it did not influence Southmark's decision not to file a proof of claim against Drexel.

Regarding causation, the bankruptcy court stated that "Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case." As the court reasoned, the Examiner notified Southmark of the Drexel proof of claim bar date and that the Examiner would not develop the securities claims; the basis for the Drexel claim was being alluded to by the media; and Southmark had made an intentional decision to pursue other avenues with its limited resources. Near the end of the disgorgement order, the court rephrased its causation finding, noting that "the *non-disclosure* did not cause Southmark to fail to timely file a proof of claim in the Drexel case." (emphasis added). The court was not limiting the generality of its

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10 For instance, Southmark's pleadings in the disgorgement proceeding specifically state that Southmark "surely would have" filed a Drexel proof of claim had Coopers "further investigated and disclosed" theories of liability against Drexel.

earlier finding, however, for this additional finding bears on the narrow compass of a violation that the court finally found after rejecting Southmark's attack on Coopers' total fee.

The court's findings of no causation, as well as its recitation of the law applicable to disgorgement, lead us to reject Southmark's additional contention that a causation finding was not necessary. Southmark is wrong because the amount of disgorgement depended in large part on the harm done to Southmark by Coopers' ethical lapse. *See In re Kendavis Indus. Int'l., Inc.*, 91 B.R. 742, 762 (Bankr. ND. Tex. 1988). The bankruptcy court wrote that he "had to consider that [causation] issue in performing the fact-specific inquiry required by case law to determine whether a professional must disgorge fees." The bankruptcy court also wrote in ruling on issue preclusion that he would have had to reappraise the disgorgement amount if he had been convinced that Coopers' omissions caused Southmark to forfeit a significant recovery opportunity in the Drexel bankruptcy. As he observed, Southmark sought a multimillion dollar recovery from Coopers. A ruling on causation was necessary to the court's decision on the amount of disgorgement.[11]

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11 Southmark disputes the bankruptcy court's discretion to award a sliding-scale disgorgement, and hence to consider causation of damages. The company is apparently persisting in its earlier contention in the disgorgement proceeding that a violation of § 328(c) requires restitution of all fees received by the professional firm. But having lost and not appealed the bankruptcy court's failure to order complete disgorgement, Southmark cannot now ignore the court's fact-specific ruling.

Southmark finally urges that causation was not actually litigated in the disgorgement proceeding. After a careful review of the record and the bankruptcy court's rulings, we cannot accept this contention. Southmark sought full return of Coopers' accounting fees in the disgorgement proceeding, while Coopers parried by arguing that it should not have to return fees for valuable services rendered in aspects of the bankruptcy other than the Drexel claims and by denying that its breaches caused Southmark's non-filing of a Drexel claim. The court balanced the facts and equities, finally arriving at a disgorgement penalty that quadrupled the amount of fees Coopers charged on Drexel matters but rejected both the complete restitution of fees sought by Southmark and restitution based on any causal connection between Coopers' actions and Southmark's failure to file a claim against Drexel.

The three criteria for issue preclusion accordingly have been satisfied on the causation of Southmark's damages with respect to the Drexel bankruptcy.

2. Claim Preclusion

Although issue preclusion prevents Southmark's attempt to relitigate a critical issue against Coopers, we must briefly distinguish that result from the lower courts' rather perfunctory reliance on claim preclusion. Claim preclusion,[12] or *res judicata*,

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12 Coopers did not raise res judicata as a defense once the case was removed to bankruptcy court. Generally speaking, pursuant to Fed. R. Civ. P. 8(c), res judicata is an affirmative defense and should not be raised *sua sponte*. *Carbonell v. Louisiana Dept. of*

bars the litigation of claims that either have been litigated or should have been raised in an earlier suit. *Super Van Inc. v. San Antonio*, 92 F.3d 366, 370 (5th Cir. 1996). The test for claim preclusion has four elements:

> (1) The parties are identical or in privity; (2) the judgment in the prior action was rendered by a court of competent jurisdiction; (3) the prior action was concluded to a final judgment on the merits; and (4) the same claim or cause of action was involved in both actions.

Swate v. Hartwell, 99 F.3d 1282, 1286 (5th Cir. 1996).

To determine whether two suits involve the same claim under the fourth element, this court has adopted the transactional test of the Restatement (Second) of Judgments, § 24. *Southmark Properties v. Charles House Corp.*, 742 F.2d 862 870-71 (5th Cir. 1984). Thus, the critical issue is whether the two actions under consideration are based on "the same nucleus of operative facts." *In re Baudoin*, 981 F.2d 736, 743 (5th Cir. 1993) (*quoting In re Howe*, 913 F.2d 1138, 1144 (5th Cir. 1990). In the instant case, the bankruptcy court found that the disgorgement proceeding and this action involved the "same nucleus of operative facts;" indeed, this action was "litigation resulting from a single

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Health & Human Resources, 772 F.2d 185, 189 (5th Cir. 1985). Without considering whether any exceptions to this rule apply in this case, this court simply notes that Southmark failed to complain of this omission on appeal, and thus, waived any objections to the bankruptcy court's *sua sponte* consideration of res judicata.

transaction with different forms of relief being requested." The court also observed that Southmark could have raised its present claims when it originally sought disgorgement of Coopers' fees: to the extent any of Southmark's claims were non-core, the district court could have adopted the bankruptcy court's findings of law and fact or withdrawn the order of reference.

Southmark asserts that the bankruptcy court erred in finding claim preclusion because disciplinary measures pursuant to procedural rules do not have preclusive effect on subsequent substantive claims. Southmark cites *Cohen v. Lupo*, 927 F.2d 363, 365 (8th Cir. 1991), which held that the tort of malicious prosecution and a Rule 11 disciplinary proceeding "differ in their nature, the elements of the claims, and the potential remedies."[13] By analogy, Southmark contends that a disgorgement proceeding pursuant to 11 U.S.C. § 328(c) should similarly not bar subsequent substantive claims, as it is essentially a remedial penalty provision. *See, e.g., Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (citing legislative history for the proposition that § 328(c) "authorizes a 'penalty' for failing to avoid a disqualifying conflict of interest").

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13 *See also Lightning Lube, Inc. v. Whitco Corp.*, 4 F.3d 1153, 1196 (3d Cir. 1993) ("the denial of a Rule 11 motion does not foreclose the assertion of a subsequent malicious prosecution suit. . . ."); *cf. Port Drum Co. v. Umphrey*, 852 F.2d 148, 150 (5th Cir. 1988) ("If Rule 11 did expand substantive rights, it would be invalid under the Enabling Act" because it regulates procedure rather than create a new substantive right or an independent cause of action).

Southmark has expressed an important insight, but we believe the roots of the claim preclusion problem lie deeper than the distinction between an ancillary penalty proceeding (*e.g.* Rule 11 or disgorgement) and a substantive cause of action. While this court has held that claim preclusion applies only to core proceedings in bankruptcy,[14] we have not determined that it applies to all core proceedings. Thus, we have held that claim preclusion does not apply where, because of bankruptcy's truncated procedures on motions to lift stay, lender liability claims could not have been brought and litigated in the earlier proceeding. D-1 *Enterps., Inc. v, Commercial State Bank*, 864 F.2d 36, 38-39 (5th Cir. 1989).[15] Whether the non-trial-type procedures utilized in the bankruptcy court to decide the disgorgement proceeding, of the unavailability of a jury trial,[16] or both circumstances may have meant that Southmark's state-law claims

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14 *Howell Hydrocarbons, Inc. v. Adams*, 897 F.2d 183, 189 (5th Cir. 1990).

15 *See also In re Howe*, 913 F.2d at 1143-47 (holding that claims raised in later litigation were barred because they could have been fully litigated in Chapter 11 reorganization process).

16 We have also held that a debtor does not waive the right to a jury trial by filing a voluntary bankruptcy case. *In re Jensen*, 946 F.2d 369 (5th Cir. 1991); *but cf. Billing*, 22 F.3d at 1242-54 (holding that debtors have no right to jury trial on malpractice claims against their attorneys); *Id.* at 1254-1260 (Sloviter, C.J., dissenting). The authority of a bankruptcy court to hold a jury trial, in cases like this, before the 1994 amendment to U.S.C. § 157(e), was in great doubt. *See* 1 Collier on Bankruptcy 15th Edition Revised ¶ 3.08 (1998).

against Coopers could not have been litigated, or litigated effectively, before the bankruptcy court in the earlier proceeding, is an interesting question. *Cf. In re Howe*, 913 F.2d at 1146. We will not speculate on complications arising from the additional possibility, mentioned by the bankruptcy court, that if Southmark had filed its malpractice action together with the motion to disgorge fees, the bankruptcy court could have heard both matters pursuant to a referral from the district court. Enough has been said to dispel the notion that claim preclusion is obviously applicable here.

CONCLUSION

Based on the foregoing discussion, we hold that the bankruptcy court had core jurisdiction over this case; that it did not abuse its discretion by refusing to remand; and that Southmark was precluded from relitigating the finding that Coopers did not cause it to fail to file a timely claim in the Drexel bankruptcy.

AFFIRMED.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	*	
SOUTHMARK	*	
CORPORATION,	*	
Debtor	*	Civil No. 3:95-CV-2193-H
	*	Bank. No. 389-36324-SAF-11
SOUTHMARK	*	
CORPORATION	*	
Appellant	*	
	*	
v.	*	
	*	
COOPERS &	*	
LYBRAND, LLP	*	
Appellee	*	

ORDER

[FILED April 15, 1996]

On February 27, 1996, the Court heard argument on Appellant Southmark Corporation's Brief, filed October 17, 1995; Appellee Coopers & Lybrand, L.L.P.'s Brief, filed November 1, 1995; and Appellant Southmark Corporation's Reply Brief, filed November 13, 1995.

After considering the pleadings, the relevant authorities, and the argument and representations of counsel, the Court was of the opinion, for reasons stated in open court, that Appellant Southmark Corporation's Appeal should be, and it was, DENIED.

Accordingly, the decision of the Bankruptcy Court is AFFIRMED.

SO ORDERED.

DATED: February 27, 1996.

/s/
BAREFOOT SANDERS, JUDGE
UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	(	
SOUTHMARK	(	
CORPORATION	(	CIVIL ACTION NUMBER
	(	
SOUTHMARK	(	
CORP.	(	
	(	
VERSUS	(	3:95-CV-2193-H NUMBER
	(	
COOPERS &	(	
LYBRAND, LLP	(	February 27th, 1996

TRANSCRIPT OF ORAL ARGUMENT
BEFORE
THE HONORABLE BAREFOOT SANDERS
UNITED STATES DISTRICT JUDGE

[FILED March 1, 1996]

APPEARANCES:

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PAMELA J. WILSON, C.S.R.,
U.S. DISTRICT COURT

Billing court -- the Billing court would have said this is not a core matter and there is no doubt that the Fifth Circuit if applies this test would hold the same way.

Thank you, Your Honor.

THE COURT: Thank you.

I will then address the matter at this time.

I'll start with the proposition which y'all are aware that findings of fact are subject to the clearly erroneous standard that the conclusions of law are reviewed de novo and there's not much point in dwelling on that.

It seems to me that the key issue here from which everything else proceeds is whether or not we are dealing with a core proceeding. And in making that decision I note that counsel dwelt a deal on the billings case. The court by necessity has reviewed also the Wood case, which controls in this circuit; the Marathon Pipeline case, which is a celebrated case in several ways; and the Sibarium case, which I handled here some years ago.

The question essentially it seems to me -- and I'm -- not being full-time bankruptcy, I'm sometimes inclined to think we dwell more on semantics than perhaps we should in a bankruptcy. But the question is whether or not the claims that are being asserted by Southmark in the removed case are, "inextricably linked" to the underlying bankruptcy.

To fit it into the Wood test, is the claim or the proceeding one that would arise only in bankruptcy. It's a little bit broader test than what I put forth in Sibarium, but it seems to me it can be harmonized.

My conclusion is that this is a core claim. It arose postpetition. It is not independent of the underlying bankruptcy. In fact, it seems to me almost totally dependent on it.

There are other cases, obviously. In the Citizen Bank and Trust Company case, which pointed out that claims that are independent or antecedent to the bankruptcy proceeding are more likely to be noncore. This does not fit in that suit of clothes.

Stockard Flying Service, 74 B.R. 704 out of the Northern District of Indiana, seems somewhat close to this. And it brings me to the conclusion that this is core.

The Solar King case out of the Western District of Texas, 142 B.R. 772, relates directly and it argues that this is core.

SPI Communications and Marketing, Inc., out of the Northern District of New York would support the conclusion that it's core.

And, of course, there are other cases. And I understand there are cases the other way.

But what it boils down to for me is that all of the Southmark claims here and the facts supporting those claims arise from duties allegedly owed by Coopers and from Coopers alleged breach of those duties during the bankruptcy case.

And, therefore, the claims are core.

Being core, mandatory abstention is not required.

I may miss the point, but it seems a little too technical, for my taste at least, to say that because Judge Felsenthal did not recite the catechism about decided not to abstain that he therefore missed his opportunity entirely. I think it's implicit in what

Judge Felsenthal ruled that he effectively decided not to abstain.

And I turn next to whether to apply res judicata. I think res judicata can be raised sua sponte. There are a number of cases cited in the briefs which I reviewed. If there's any problem about 56(c) -- application of 56(c), I think it was harmless.

The disputed element here as to whether or not the elements are res judicata are present, the only disputed element, and I think counsel have agreed on that, that there is one disputed element, and that is, whether both suits involve the same kind of claim and the same kind of facts. Now, there may be a little bit different kind of claim, but the underlying facts that are asserted are the same.

The other criteria of res judicata are met.

Here I find and conclude that the underlying facts and the disgorgement motion in the underlying proceeding, that is the bankruptcy court, related to whether Coopers alleged nondisclosure about the Drexel bankruptcy was improper. Those same facts are relied on in the lawsuit which has been removed here from the state court. And this seems to me to be -- lead to the conclusion that that one disputed element of res judicata is met and the rest not being contested that res judicata does apply here.

As to whether or not collateral estoppel need to be addressed, I don't really think it does. I will address it, nevertheless, that is: Was the issue here litigated and was the determination of the issue in the prior action necessary to the judgment?

It seems clear to me that causation was actually litigated in the bankruptcy court and the bankruptcy action. And, in fact, on the pretrial order on

appellant's disgorgement motion a contested issue of fact addressed the issue of causation.

I understand there is a recent case, out of the District of Colombia, the Henry case, counsel I think may have alluded to that, raising a question as to whether causation is a necessary element. That's not the law in the Fifth Circuit as I read it. It certainly was not the law when Judge Felsenthal ruled.

I think there might be, if we decided to get right down to it, a question as to whether or not that having been cause -- causation having been inserted into the pretrial order as a contested issue of fact, whether it waived any complaint that the appellant might make about causation being necessary to the judgment of the original bankruptcy court.

I therefore, to sum up, find: One, that it's a core case; second, that Judge Felsenthal decided not to abstain, effectively did so, and that he was correct; that res judicata may be raised sua sponte and was nothing improper about that; that res judicata applies here; and that the doctrine covers the disputed issue here and in effect eviscerates Southmark's claims in the bankruptcy court; and even if collateral estoppel were necessary to be applied, that collateral estoppel would also require affirmance of the bankruptcy court's ruling.

So the judgment of the bankruptcy court will be affirmed.

I appreciate counsel's good presentation.

We'll be in recess.

(Recess taken.)

IN THE
UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE: SOUTHMARK CORPORATION, DEBTOR.	§	CASE NO. 389-36324-SAF-11
SOUTHMARK CORPORATION, PLAINTIFF, VS. COOPERS & LYBRAND, L.L.P., DEFENDANT.	§	ADVERSARY NO. 395-3205
COOPERS & LYBRAND, L.L.P., THIRD-PARTY PLAINTIFF, VS. CHARLES B. BREWER, and THOMPSON & KNIGHT, L.L.P., THIRD-PARTY DEFENDANTS.	§	

MEMORANDUM OPINION AND ORDER

[ENTERED August 15, 1996]

Coopers & Lybrand, L.L.P., moves the court for a judgment on the pleadings dismissing this adversary proceeding. Southmark Corporation moves the court to stay its consideration of that motion pending Southmark's motion for abstention or, in the alternative, remand the complaint to the state court. The third party defendants, Charles B. Brewer and Thompson & Knight, L.L.P., move the court to dismiss the third party complaint. The court conducted a hearing on these motions on July 28, 1995.

Because Cooper & Lybrand's motion for a judgment on the pleadings is dispositive, the court only addresses that motion. The motion and response focus on collateral estoppel, specifically addressing the issue of causation. The hearing however also covered the elements of res judicata.

Southmark filed its petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989. By order entered September 8, 1989, the bankruptcy court directed that the United States Trustee appoint an examiner. By order entered October 30, 1989, the court conditionally approved the employment by the examiner of Coopers & Lybrand as his accountants. By order dated February 1, 1990, the court confirmed the approval of the examiner's retention of Coopers & Lybrand, effective as of September 26, 1989. *In re Southmark*, 113 B.R. 280, 284 (Bankr. N.D. Tex. 1990).

The court conducted a hearing on Coopers' application for final allowance of compensation and

reimbursement of expenses on November 14, 1990. The court entered its final order on that matter on March 5, 1991.

On January 4, 1994, Southmark filed a motion to reconsider the order awarding Coopers' final compensation. In its motion, filed under Bankruptcy Rule 9024, Southmark complained about Coopers' failures to disclose fully its relationship with Drexel Burnham Lambert, alleging that Coopers did not disclose a decision not to pursue an investigation of certain issues pertaining to Drexel's transactions with Southmark. Southmark further alleged that as a result of the alleged non-disclosure, Southmark ultimately failed to timely file a proof of claim in the Drexel bankruptcy case, costing Southmark a significant dividend from the Drexel bankruptcy estate.

The Rule 9024 motion sought a disgorgement of Coopers' fees, with Southmark contending that Coopers was not disinterested and that Coopers held an interest adverse to the Southmark estate. The motion invoked Fed. R. Civ. P. 60(b)(6), fraud on the court.

Coopers filed a response to the motion. The court held a status conference on the motion at which time the court agreed to conduct a Fed. R. Civ. P. 12(b)(6)-type analysis. The parties submitted written arguments. The parties argued whether Southmark's motion would be governed by Rule 60(b)(3); covering fraud, misrepresentation and other misconduct of an adverse party. The court entered an order on June 6, 1994, denying Southmark's motion based on Rules 60(b)(2) and (3), but continuing the matter as to Rule 60(b)(6). Also on June 6, 1994, the court entered a scheduling

order setting an evidentiary hearing on the merits of the motion.

The parties submitted a joint pretrial order. The court conducted an evidentiary hearing on December 20, 1994. With the pre-hearing motions, scheduling order and the pretrial order, the motion proceeded as if the court had formally applied the adversary proceeding rules. Bankruptcy Rule 9014. The court entered its memorandum opinion and order on March 1, 1995. On April 4, 1995, the court entered a judgment modifying final order directing that Southmark recover $585,042.48 from Coopers plus post-judgment interest allowed by Title 28 of the United States Code. Neither party appealed the order or judgment. Coopers paid Southmark the amount of the judgment.

To determine the amount of the judgment, the court had to engage in a fact specific inquiry. In doing so, the court specifically found that "Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case." The court also found "While the non-disclosure did not cause Southmark to fail to timely file a proof of claim in the Drexel case, the non-disclosure impeded the court's function to assure the integrity of an investigation by professional persons with undivided loyalty."

On April 7, 1995, Southmark commenced this action against Coopers in the 134th Judicial District Court, Dallas County, Texas. On May 8, 1995, Coopers filed its answer and affirmative defenses. On May 15, 1995, Coopers filed a notice of removal to this court.

Southmark's complaint is premised on the same factual allegations as its earlier Rule 9024 motion.

On those factual allegations, Southmark alleges claims for relief based on breach of contract, fraud and deceit, breach of fiduciary duty and negligent misrepresentation. Southmark seeks recovery of compensatory damages allegedly caused by Coopers' conduct, and exemplary damages, attorneys fees and pre- and post-judgment interest. Southmark premises its damages on the failure to file a proof of claim in the Drexel bankruptcy case.

Three requirements must be met to apply collateral estoppel. Coopers must establish that (1) the issue at stake must be identical to the one involved in the prior action; (2) the issue must have been actually litigated in the prior action; and (3) the determination of the issue in the prior action must have been a necessary part of the judgment in that earlier action. *Recoveredge L.P. v. Pentecost*, 44 F.3d 1284, 1290 (5th Cir. 1995).

Coopers conduct is identical. Southmark's conduct is identical. From that conduct, on the Rule 9024 motion Coopers submitted the contested fact to the court of "Whether any damages to Southmark as a result of its failure to assert timely claims against Drexel were caused by the act or omission of any person other than Southmark itself." Joint Pretrial Order, p. 17. The parties actually litigated that issue. The court had to consider that issue in performing the fact-specific inquiry required by case law to determine whether a professional must disgorge fees. The court could not have decided the disgorgement issue without deciding that damages causation issue. Indeed, had the court found that Coopers caused Southmark to fail to timely file the Drexel proof of claim, the disgorgement judgment necessarily would have been different. Southmark sought a multi-million dollar recovery on its

contention that Coopers caused the failure to file the proof of claim. The court necessarily had to decide the causation issue to decide the Rule 9024 motion.

Southmark now alleges breach of contract, fraud and deceit, breach of fiduciary duty and negligent misrepresentation. To recover damages on any or all of those claims, Southmark would have to establish that Coopers caused Southmark to fail to file the Drexel proof of claim, resulting in Southmark's damages. This court has already found, after a fully litigated evidentiary hearing involving both parties, that Coopers did not cause Southmark to fail to file timely the proof of claim. Coopers therefore did not cause Southmark to suffer the damages from Southmark's failure to recover a dividend in the Drexel case.

The legal standards must be the same. The causation of damages element considered for the Rule 9024 motion disgorgement analysis is the same causation of damages element in each of the claims now being asserted. *See Recoveredge*, 44 F.3d at 1294. Southmark contends, however, that it had a greater burden of proof in the prior proceeding than in this proceeding. Southmark's written papers in the prior proceeding did not urge the court to apply a clear and convincing burden of proof for causation of damages. Coopers did not urge that standard, either. Southmark does not present authority that after *Grogan v. Garner*, 498 U.S. 279, 286 (1991), the burden of proof should not be preponderance of the evidence. The same legal standards apply.

Application of the collateral estoppel doctrine results in Southmark's inability to establish a necessary element for recovery under any and all of its alleged claims. The motion for a judgment on the pleadings must be granted.

Four requirements must be met to apply res judicata: (1) the parties must be identical in both suits; (2) the prior judgment must have been rendered by a court of competent jurisdiction; (3) there must be a final judgment on the merits; and (4) the same cause of action must be involved in both cases. *Matter of Baudoin*, 981 F.2d 736, 740 (5th Cir. 1993).

The parties to the complaint are the identical parties to the Rule 9024 motion. A final judgment has been entered in the Rule 9024 matter. Indeed that judgment has been paid.

The causes of action in this adversary proceeding are the same as in the Rule 9024 motion. Federal law determines the preclusive effect of a prior federal judgment. The Fifth Circuit has "adopted a transactional test for determining whether two complaints involve the same cause of action. Under this approach, the critical issue is not the relief requested or the theory asserted but whether the plaintiff bases the two actions on the same nucleus of operative facts. If the factual scenario of the two actions parallel, the same cause of action [is] involved in both. The substantive theories advanced, forms of relief requested, types of rights asserted, and variations in evidence needed do not inform this inquiry." *Agrilectric Power Partners, Ltd. v. General Electric Co.*, 20 F.3d 663, 665 (5th Cir. 1994).

The two matters present the same factual scenario. The two present the same nucleus of operative facts. The same causes of action are therefore involved in this complaint and the prior Rule 9024 motion between the parties.

The final inquiry involves whether the prior judgment was rendered by a court of competent jurisdiction. The parties do not contend otherwise. This court had jurisdiction to enter the judgment on the Rule 9024 motion.

Of course, the inquiry must go further. *See Baudoin*, 981 F.2d at 740-744. This court has jurisdiction over this adversary proceeding. 28 U.S.C. §§157 and 1334(b). Neither party contends otherwise. However, Southmark contends that the complaint raises non-core matters. Coopers argues that the complaint raises core matters.

If the matter raised by the complaint is core, the inquiry ends. *Baudoin*. If the matter is no-core, the court still has jurisdiction. If the parties did not consent to entry of a final order by this court on the non-core matter, the court would issue proposed findings of fact and conclusions of law for de novo review in the District Court. But, more significantly, and dispositively, the United States District Court has jurisdiction. 28 U.S.C. §1334(b). The matter is before this court by order of reference which can be withdrawn by a stroke of the District Court pen. 28 U.S.C. §157(a); Bankruptcy Rule 5011(a). Res judicata bars all claims that were or could have been advanced in support of the cause of action on the occasion of its former adjudication, not merely those that were adjudicated. *Matter of Howe*, 913 F.2d 1138, 1144 (5th Cir. 1990). The court recognizes the cases that hold that certain issues must be raised by an adversary proceeding and cannot be included in a contested matter. That is not the issue. This is not a case, for example, where res judication would not apply to bar an action to avoid a lien after a motion to lift stay. Rather, this is litigation resulting from a single

transaction with different forms of relief being requested. The claims raised in this complaint and the claims raised in the Rule 9024 motion could have been raised at one time in the United States District Court, with a referral to this court. The District Court is a court of competent jurisdiction. This court would have been a court of competent jurisdiction. The only procedural issue would have been whether this court or the District Court would have finally decided the non-core matters, if any.

The Fifth Circuit recognizes the important interest in the finality of judgments in bankruptcy cases. *Baudoin*, 981 F.2d at 739. This court's determination of the Coopers' issues has the effect of a judgment rendered by the District Court. Any attempt by the parties to relitigate any of the matters that were raised or could have been raised should be barred by the doctrine of res judicata. This case demonstrates the imperative need for unceasing vigilance in the application of res judicata that the Fifth Circuit addressed in *Baudoin*.

Based on the foregoing,

IT IS ORDERED that the motion to stay consideration of the motion for judgment on the pleadings is DENIED.

IT IS FURTHER ORDERED that the motion for judgment on the pleadings is GRANTED.

IT IS FURTHER ORDERED that this adversary proceeding is DISMISSED.

IT IS FURTHER ORDERED that the third party complaint against Charles B. Brewer and Thompson & Knight, L.L.P., is DISMISSED.

IT IS FURTHER ORDERED that the motion to abstain or, in the alternative, to remand is DENIED as moot.

Signed this 11th day of August, 1995.

/s/
Steven A. Felsenthal
United States Bankruptcy Judge

IN THE
UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	§	
	§	
SOUTHMARK	§	CASE NO.
CORPORATION,	§	389-36324-SAF-11
	§	
DEBTOR.	§	

MEMORANDUM OPINION AND ORDER

[ENTERED March 1, 1995]

Southmark Corporation moves the court under Bankruptcy Rule 9024 for relief from the final order awarding compensation to Coopers & Lybrand. The Southmark examiner employed Coopers to do accounting investigatory work. Coopers had performed accounting and auditing work for Drexel Burnham Lambert. Southmark contends that Coopers failed to disclose to the court, in violation of the Bankruptcy Code and court order, that, during its engagement by the examiner, it discontinued an investigation of certain issues pertaining to Drexel's transactions with Southmark. Southmark asserts that this non-disclosure requires relief from the compensation award and a disgorgement of compensation because Coopers held an interest materially adverse to the bankruptcy estate. The court conducted an evidentiary hearing on December 20, 1994, at which, by stipulation, the parties submitted the issue on a written record.

The determination of compensation under 11 U.S.C. §330(a) for professional persons employed under 11 U.S.C. §§ 105(a) and 327(a) constitutes a core matter over which this court has jurisdiction to enter a final order. 28 U.S.C. §§157(b)(2)(A) and (O) and 1334. By Bankruptcy Rule 9024, this court may grant relief from such a final order. This memorandum opinion contains the court's findings of fact and conclusions of law required by Bankruptcy Rules 7052 and 9014.

Bankruptcy Rule 9024 applies Fed. R. Civ. P. 60(b). By order entered June 6, 1994, the court dismissed claims for relief under Rule 60(b)(2) and (3) but held that Southmark's motion alleged a claim for relief from the final order under Rule 60(b)(6). The court must determine whether Southmark has established a basis to order a disgorgement of compensation under Rule 60(b)(6).

The court adopts as findings of fact the parties' statement of stipulated facts in the pretrial order.

Southmark filed its petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989. By order entered September 8, 1989, the court directed that the United States Trustee appoint an examiner to investigate and review allegations of fraud, dishonesty, incompetence, mismanagement or irregularity in the pre-petition management of Southmark and to recommend causes of action discovered in the course of the investigation and review. On the same day the court approved the appointment of Neal Batson as the examiner.

By order entered October 30, 1989, the court conditionally approved the employment by the examiner of Coopers as his accountants. By order dated February 1, 1990, the court confirmed the

approval of the examiner's retention of Coopers, effective as of September 26, 1989. *In re Southmark Corp.*, 113 B.R. 280, 284 (Bankr. N.D. Tex. 1990).

Drexel Burnham Lambert provided investment banking and financial consulting services to Southmark pre-petition. Indeed, Drexel had been Southmark's investment banker on the one billion dollar high risk bonds that were unpaid on the date of the bankruptcy petition. Southmark had extensive dealings with Drexel. In support of its eligibility for employment, Coopers disclosed, by sworn affidavit, that "it provides accounting and consulting services for Drexel in matters unrelated to this case." Coopers did not disclose to the court that it also provided audit services for Drexel. Coopers did not disclose to the court that Drexel paid Coopers approximately $6.7 million for 1987 services, $6.9 million for 1988 services and $4.9 million for 1989 services. The examiner stated in the employment application that, "[t]o the best of Examiner's knowledge, said accounting firm is eligible and qualified to represent the Examiner."

Prior to the examiner's appointment Drexel had pled guilty to federal criminal charges and had agreed to a comprehensive consent decree with the Securities and Exchange Commission settling a civil complaint filed by the SEC. Under the consent decree, a $650 million fund was established to satisfy civil securities claims against Drexel, as well as for other matters. On February 13, 1990, Drexel's parent, the Drexel Burnham Lambert Group, Inc., filed a petition for relief under Chapter 11 of the Bankruptcy Code. The Drexel bankruptcy court set a November 15, 1990, bar date for filing proofs of claims against the Drexel Group.

The examiner's charge covered Southmark's pre-petition transactions with Drexel.

The court conducted two hearings concerning employment of professional persons by the examiner. Coopers' disclosure notwithstanding, Southmark did not object to the employment.

The court determined that the examiner could employ professional persons under §105(a) in this case. *Southmark*, 113 B.R. at 284. Employment eligibility and compensation standards were based, however, on §§327(a) and 330(a). *Id.* Under §327(a), Coopers could not hold or represent an interest adverse to the bankruptcy estate and had to be disinterested as defined by §101(14). Bankruptcy Rule 2014 requires that a professional person seeking employment in a bankruptcy case submit a "verified statement . . . setting forth the person's connections" to the debtor, creditors and other parties in interest. Section 328(c) provides that the court may deny compensation for a professional person employed under §327 if, at any time during that employment, the person is not disinterested or holds or represents an interest adverse to the interest of the estate with respect to the matter on which the person is employed.

By order dated December 15, 1989, this court directed:

> If any party in interest contends that any professional . . . has a conflict of interest that would affect the professional's right to receive compensation, provided the alleged conflict has been disclosed, the party in interest shall raise its contention at the first hearing on

interim compensation following the disclosure or shall thereafter be estopped from doing so.

Southmark did not contend at the first interim compensation hearing that Coopers' disclosed work for Drexel constituted a disqualifying conflict.

The court further ordered that all professional persons had a "continuing obligation to disclose any matter that may affect qualification for court-approved employment under the Bankruptcy Code or disqualification under any relevant ethical consideration."

Coopers engagement team included partners David Carpenter and Knute Kurtz and managers William Galbally, Selene Yu, David Kennedy and Steve Schockett. Carpenter assigned Galbally to investigate possible claims against Drexel. Galbally began his investigation of Drexel in late October 1989. From October 1989 to early December 1989, Galbally billed under 16 hours for Drexel-related work. Galbally's investigation consisted of reviewing materials available in the public domain such as news articles regarding Drexel's activities with Southmark. Galbally also reviewed Drexel brokerage firm materials and Southmark's 1989 Annual Report.

In December 1989, based upon his initial investigation, Galbally concluded that Southmark possibly had significant securities' claims against Drexel that warranted further investigation. Galbally updated Kurtz on the status of his Drexel investigation and expressed his desire to investigate further. On the evening of December 4, 1989, Carpenter and Kurtz met with Galbally at Galbally's apartment to discuss a presentation that Galbally delivered to the examiner earlier that day on non-

Drexel related matters. Galbally again voiced his enthusiasm to the partners about the Drexel investigation and presented Carpenter with a Wall Street Journal article about Drexel.

Carpenter, however, decided to reassign Galbally. Galbally could either be transferred to Philadelphia to work on other engagements or to Atlanta to work on Southmark preference issues with Kennedy. Galbally chose the latter and was transferred to Atlanta. Carpenter then reassigned responsibility for gathering the underlying facts supporting Southmark's potential securities claims against Drexel to Jeffrey Kessler. Kessler did not have investigatory experience. After the reassignment, Coopers billed the examiner over two hundred hours for work involving Southmark transactions with Drexel. Coopers analyzed transfers from Southmark to Drexel for avoidability under Chapter 5 of the Bankruptcy Code. Coopers also investigated and reported to the examiner how Southmark invested the proceeds of the high risk bonds capitalized in the market through Drexel's investment banking services. Coopers did not pursue the securities claims.

Coopers did not file a supplemental disclosure with the court informing the court that it would not investigate potential Southmark securities claims against Drexel.

On April 17, 1990, the examiner informed Southmark regarding Drexel claims. The examiner recognized that Southmark may have securities claims against Drexel but informed Southmark that he would not devote additional resources to further investigate those claims. He reminded Southmark about the Drexel civil disgorgement fund and encouraged Southmark's counsel to pursue the

Drexel issues. The examiner deployed his resources based on the time restraints created by the court's setting of the Southmark confirmation hearings and the Drexel bankruptcy. Because of the exigencies regarding the confirmation process, Southmark did not then pursue the Drexel claims.

The court conducted a hearing on Coopers' application for final allowance of compensation and reimbursement of expenses on November 14, 1990. The court entered its final order on that matter on March 5, 1991, awarding Coopers' approximately $3.7 million. Southmark filed this motion for relief from that order on January 4, 1994.

Coopers disclosed to the court that it provided accounting and consulting services for Drexel on matters "unrelated to this case." Coopers did not disclose to the court that the work included audit services. Coopers did not disclose to the court that Drexel paid Coopers $18.5 million for those services during the 2 1/2 years before the Southmark bankruptcy petition. During the course of Coopers employment, Coopers did not disclose to the court that it recognized but did not pursue an investigation of Southmark securities claims against Drexel.

Based on this court's order entered June 6, 1994, the court must determine whether these non-disclosures support relief under Rule 60(b)(6). Southmark contends that had the disclosures been made, the court would have found an adverse interest or would have found that Coopers was not disinterested for purposes of continued employment under §327 and for payment under §§328(c) and 330(a). Southmark argues that the effect amounts to a fraud on the court. The continuing disclosure obligation imposed by the court pursuant to the Bankruptcy Code implicates a public policy interest

justifying relief from the judgment under Rule 60(b)(6).

The court must determine employment standards and compensation under the Code. To enable the court to fulfill that function, the professional person must make a full disclosure under Rule 2014 of all its connections with the debtor, creditors or parties in interest. It must make a full disclosure of any entity that might have an interest adverse to the estate. By court order, the professional person employed in this case had a continuing obligation to disclose these connections as they become known or developed. Southmark specifically argues that the activities violate the public interest in the fair and equitable treatment of creditors and violate Coopers' duties to the court, thereby threatening the integrity of the judicial process that is designed to assure that the examiner employ only disinterested professional persons who hold or represent no interest adverse to the bankruptcy estate. *See Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994); *In re Leslie Fay Companies, Inc.*, 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994). Southmark contends that Coopers non-disclosures amount to a fraud on the court, supporting relief from the final compensation order under Rule 60(b)(6).

A professional person who is not disinterested or who holds or represents an interest adverse to the estate may not be employed under §327(a). A professional person not eligible for employment under §327(a) may not be compensated under §330(a) and may be subject to the denial of compensation under §328(c). *In re Federated Department Stores, Inc.*, ___ F.3d ___ (6th Cir. 1995), 1995 WL 13851. Compensation should not be allowed for services rendered by a professional

person who holds conflicting interests even if no fraud or unfairness resulted from the conflict. *Woods v. City National Bank & Trust Co. of Chicago*, 312 U.S. 262, 266 (1941) (under the Bankruptcy Act). The bankruptcy court cannot speculate on what might have been in the absence of a conflict. Where an actual conflict arises, compensation should be denied. *Id.*

Because the court must apply this statutory and case law in the context of a Rule 60(b)(6) motion, the court must focus on the non-disclosures to the court. Pre-petition, Drexel had pled guilty to a criminal charge and had entered a consent decree with the SEC establishing a $650 fund for securities claims. Drexel had been Southmark's investment banker and advisor. Southmark owed $1 billion of high risk bond claims. Within 90 days of its bankruptcy petition, Southmark wrote down the value of its assets by $1 billion eliminating any equity for its publicly traded stock. *See, Southmark*, 113 B.R. at 283. Coopers was engaged by the examiner to investigate Southmark's transactions with, among others, Drexel. Coopers disclosed that it had performed accounting work for Drexel.

Coopers did not inform the court that the accounting work included auditing work and resulted in $18.5 million in fees in the 2 1/2 years before the Southmark bankruptcy case. Coopers investigated transfers by Southmark to Drexel for avoidance analysis and investigated Southmark's investment of high yield bond funds. But when it came time to investigate Southmark's securities claims against Drexel, Coopers pulled its staff, did not pursue the investigation and did not disclose this activity to the court.

Wall Street Journal newspaper articles were already articulating a basis for securities claims. Coopers knew about those articles. Galbally expressed a desire to pursue those claims. Carpenter moved Galbally from the assignment. The parties dispute the actual exchange between Carpenter and Galbally when Carpenter removed him from the assignment. The testimony conflicts. But the actual exchange is not relevant. All that matters is what Coopers actually did or did not do and what Coopers did or did not disclose to the court. Coopers did not pursue the Southmark securities claims against Coopers' client, Drexel. Coopers reassigned its investigatory personnel. Coopers did not inform the court of the magnitude of its work for Drexel. It is one thing to analyze avoidance actions under the Bankruptcy Code or what Southmark did with the high yield bond revenue, it is another thing to investigate securities issues against a client that has paid the accountant $18.5 million in 2 1/2 years, has pled guilty to criminal charges, has entered a consent decree with the SEC establishing a $650 fund and whose parent has filed a Chapter 11 petition.

The court finds that Coopers' failure to fully disclose connections and activities with and regarding Drexel prevented the court from fully performing its function under the Bankruptcy Code and thereby frustrated the purposes of the Code to assure that the professional person employed by the examiner tenders undivided loyalty and provides untainted advice and assistance. *Rome*, 19 F.3d at 58. The court, not the applicant or the professional person, must make the assessment of the §327(a) criteria. The professional person must disclose and continue to disclose all connections that may effect employment eligibility. *Rome*, 19 F.3d at 58-60.

Failure to do so constitutes a basis for relief from the compensation order under Rule 60(b)(6).

The court entered an order requiring continuing disclosure and a procedure for timely and fairly adjudicating the effects of the disclosures. Coopers should have disclosed that its accounting work for Drexel included audit work and the amount of the fees paid by Drexel. When the securities claims theories emerged and Drexel reassigned its personnel, in effect, terminating an investigation of those claims, Coopers should have disclosed to the court that it would not be pursuing those claims. Under the court's procedure, the issue of disinterestedness and material adverse interest would have been addressed at the next interim compensation hearing. The issue would have been resolved, protecting Southmark and its estate, and, for that matter, Coopers and the examiner. The integrity of the Drexel analysis would have been preserved by the resulting court determinations.

A total disgorgement of compensation would be required. *Federated Department Stores*, __ F.3d __, 1995 WL 13851. Bankruptcy courts, however, usually assess compensation disgorgement issues under the particular facts of each case. *Matters of Prudhomme*, 43 F.3d 1000, ___ (5th Cir. 1995); *see, also, Leslie Fay*, 175 B.R. at 533 (discussing conflict analysis). While courts should tend to deny compensation when a professional person holds an interest adverse to the bankruptcy estate or is not disinterested, the court must nevertheless exercise discretion under the facts of a case to assure appropriate relief in complex circumstances. *Gray v. English*, 30 F.3d 1319 (10th Cir. 1994). The court ultimately then must engage in a fact specific inquiry in which the court may balance benefit and/or harm to the estate,

time and labor employed, egregiousness of the professional person's non-disclosure, and so forth. *See In re Kendavis Industries Intern., Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988).

Southmark concedes that Coopers performed valuable services for the examiner on matters not involving Drexel. Indeed Southmark employed Coopers post-confirmation to assist with its proof on the numerous avoidance actions filed in this court. Southmark has recovered substantial sums form its avoidance actions.

Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case. The examiner alerted Southmark to the Drexel proof of claim bar date and that the examiner would not be developing the securities claims. The basis for the claim was already being suggested in the media. Southmark made conscientious decisions on the deployment of its resources.

Yet, Southmark might have pursued a significant claim against Drexel. Indeed Southmark will likely recover a substantial sum in the range of $20 million from Michael Milken, the director of Drexel's high yield department.

Coopers held a material adverse interest to the bankruptcy estate concerning Drexel. Drexel had paid Coopers $18.5 million in the 2 1/2 years before the bankruptcy petition. Yet Coopers only disclosed that is provided consulting and accounting services to Drexel not related to Southmark. Coopers did not investigate the securities claims against Drexel. Coopers did not disclose to the court that it would not. Drexel had a significant involvement in Southmark's financial transactions, effecting unpaid claims against the Southmark estate and virtually

worthless equity securities. Coopers employment should not have extended to any work regarding Drexel because it held a materially adverse interest to the bankruptcy estate. The examiner's decision not to pursue the Drexel investigation based on time constraints has no bearing on Coopers failure to disclose to the court.

The court concludes that Coopers should disgorge compensation paid in connection with work regarding Drexel. Coopers introduced evidence that Drexel-related fees for the examiner amounted to $55,000. The court accordingly orders a disgorgement of $55,000.

Coopers assignment in the case would have been altered had it made full disclosures. Had it told the court that it had effectively terminated the securities claims investigation on December 4, 1989, the development of those claims would have proceeded on a different basis. Had this issue been confronted in December 1989, the examiner and Southmark would have faced different circumstances concerning Drexel when the examiner confronted his time constraints in April 1990, and when Southmark made its decisions regarding deployment of its available resources to address the exigencies it faced. While the non-disclosure did not cause Southmark to fail to timely file a proof of claim in the Drexel case, the non-disclosure impeded the court's function to assure the integrity of an investigation by professional persons with undivided loyalty. The court should not be left to speculate on how the securities claim against Drexel would have been investigated. Considering the recovery from the Milken litigation, the court must treble the disgorgement amount for an additional sanction of $165,000.00.

Coopers must also reimburse Southmark for the costs and attorneys fees incurred in prosecuting this motion.

Conclusion

Southmark shall recover $220,000.00 from Coopers plus Southmark's attorneys fees and expenses in prosecuting this motion. This amount shall bear post-judgment interest from the date of entry of an order pursuant to Title 28, United States Code. Counsel for Southmark shall file an affidavit detailing the costs and fees incurred by Southmark in prosecuting this motion. Counsel for Southmark shall also prepare an order granting relief from the final order entered March 5, 1991, pursuant to this ruling and an order granting recovery in the specified amounts.

Signed this 27 day of February, 1995.

/s/
Steven A. Felsenthal
United States Bankruptcy Judge

No. 95-340B-G

SOUTHMARK CORPORATION,	§	IN THE DISTRICT COURT
Plaintiff,	§	
VS.	§	OF DALLAS COUNTY, TEXAS
COOPERS & LYBRAND, L.L.P.,	§	134th JUDICIAL DISTRICT
Defendant.	§	

ORIGINAL PETITION

[FILED April 7, 1995]

SOUTHMARK CORPORATION ("Southmark") complains of COOPERS & LYBRAND, L.L.P. ("Coopers") as follows:

I. PARTIES

1. Plaintiff Southmark is a Georgia corporation with its headquarters in Dallas County, Texas. Except as otherwise specified, the term "Southmark" as used herein includes all wholly or partially owned Southmark subsidiaries.

2. Defendant Coopers is a limited liability partnership and a firm of certified public accountants which practices accounting throughout the United States, including the State of Texas. One or more of its partners and managing partners are residents and citizens of the State of Texas, including, but not limited to, Jerry Walker, Managing partner of the Dallas, Texas office.

Defendant Coopers is thus a citizen of the State of Texas for purposes of this suit. Defendant Coopers may be served with process by serving its managing partner, Mr. Jerry Walker, at his regular place of business, 1999 Bryan Street, Suite 3000, Dallas County, Texas 75201-3185.

II. JURISDICTION AND VENUE

3. Southmark sues Coopers for breach of contract, fraud, negligent misrepresentation, breach of fiduciary duty, actual (direct and consequential) damages, exemplary damages, attorneys' fees and interest. Southmark's claims arise out of Coopers' acts, omissions and deceit in purportedly performing professional services on behalf of, and for the benefit of, Southmark. Jurisdiction is proper because the amount in controversy substantially exceeds the Court's minimum jurisdictional limits, and because Coopers is personally present in the State of Texas.

4. Venue is proper in Dallas County, Texas, under Tex. Civ. Prac. & Rem. Code §§ 15.001 because the alleged causes of action occurred in part in Dallas County, Texas.

III. FACTUAL BACKGROUND

5. Southmark was organized in 1970 as a Maryland real estate investment trust, later known as Southmark Properties. In 1981, Gene E. Phillips and William S. Friedman acquired control of Southmark Properties and appointed themselves chairman and vice-chairman, respectively. Southmark Properties' headquarters were moved to Dallas, Texas, and on May 1, 1982, Southmark Properties was converted to a Georgia corporation and its name was changed to Southmark Corporation.

6. The principal business of Southmark was sponsoring private and publicly syndicated real estate partnerships. Through private and public borrowings, Southmark acquired other real estate companies, as well as a savings and loan associations and insurance companies.

7. In April, 1989, following two years of increasing financial distress, Southmark announced a $1 billion write-down of its asset values. This write-down wiped out Southmark's shareholders' equity, reducing equity from $605 million to negative $428 million. On July 14, 1989, Southmark filed a Chapter 11 bankruptcy proceeding in Atlanta. The case was subsequently transferred to Dallas. Under the plan of reorganization adopted by the Bankruptcy Court, holders of Southmark's more than one billion dollars in public debt received approximately five cents on each dollar of their investment in cash, as well as securities in the reorganized Southmark which could be worth as much as another 15 cents on the dollar.

8. From 1982 until shortly before Southmark's bankruptcy in 1989, Drexel Burnham Lambert, Inc. ("Drexel") served as underwriter, broker and financial advisor to Southmark and several of its subsidiaries. Virtually all of Southmark's dealings with Drexel were directly with the High Yield Department, run by Michael Milken. Through the High Yield Department, Drexel was able to foster and sustain the illusion of a liquid market for issues of high yield corporate debt and preferred stock, which eventually and more accurately came to be known as "junk bonds." Underwriting junk bond issues and manipulating the junk bond markets

earned Drexel exorbitant profits through underwriting fees, markups and trading profits.

9. Issuers of Drexel-underwritten bonds were forced through a variety of means to invest a portion of the issue proceeds in junk bonds underwritten by Drexel for other clients. Drexel clients who refused to invest in junk bonds found Drexel unwilling to underwrite further debt or preferred stock issues, which were frequently necessary just to retire maturing debt or redeem earlier preferred stock issues. Drexel clients who did not continue to purchase Drexel-underwritten bonds for their own portfolios also found Drexel unwilling to sell bonds the companies already owned.

10. Through the efforts of Drexel, Southmark raised well over a billion dollars through high-interest public debt issues, which quickly imposed huge interest expense and principal repayment obligations on Southmark. The debt incurred by Southmark was well in excess of the legitimate operational needs of the company. Southmark was induced by Drexel to invest the excess funds, over $400 million, in high-yield bonds of other Drexel clients. Southmark ultimately lost in excess of $150 million on these junk bonds in 1988 and 1989. The crushing burden of debt service on junk bond issues, combined with devastating losses in its junk bond portfolio, contributed directly and substantially to Southmark's demise.

11. On July 28, 1989, shortly after it filed for bankruptcy, Southmark moved the Bankruptcy Court for the appointment of an Examiner, stating, "the Debtor believes that it is in the best interests of the estate and this Chapter 11 case to have a disinterested, independent individual review and investigate the pre-Chapter 11 activities of the

debtor as they relate to third party transactions and relationships, and potential causes of action against such third parties on behalf of Southmark and the estate." Southmark sought "an unbiased, independent assessment as to whether legal action by Southmark against various third parties, including any of its former officers and directors, is appropriate and should be pursued."

12. On September 8, 1989, the Bankruptcy Court issued an order approving the appointment of Neal Batson, a partner in the firm of Alston & Bird, as Examiner. The order charged the Examiner with the "investigation and review of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor, and . . . making recommendations as to causes of action discovered in such investigation and review." The Court specifically authorized the Examiner to retain "attorneys and accountants to assist the Examiner in investigation and review, the fees and expenses of such professionals to be paid from the estate upon proper application." On September 14, 1989, the Court approved the appointment of Alston & Bird as attorneys to assist the Examiner.

13. On September 26, 1989, the Examiner applied to the Court for an order authorizing the employment of Coopers as accountants to the Examiner, to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor. In addition, Coopers was to explore possible causes of action that Southmark might have against various third parties arising out of such activities. Coopers received fees in excess of $4 million directly from Southmark for this engagement.

Among the potential claims that Southmark had were claims against Drexel arising out of Drexel's roles as underwriter of bonds sold by Southmark and as broker for bonds purchased by Southmark. Drexel, however, was also a large and lucrative audit client of Coopers.

14. Attached to the application of the Examiner was an affidavit from David A. Carpenter, the engagement partner from Coopers. In paragraph 3 of that affidavit, Carpenter listed all "known connections" between Coopers and other parties in interest. Mr. Carpenter noted that "Coopers & Lybrand provides accounting and consulting services for Drexel in matters unrelated to this case." Mr. Carpenter did not indicate that Coopers' relations with Drexel would in any way impede or interfere with its duties as accountants to the Examiner.

15. The appointment of Coopers was subsequently approved by the Court, effective September 26, 1989. Most of the investigative work between September 26, 1989 and July 9, 1990, the date of the Examiner's final report, was performed by Coopers. Indeed, Coopers itself wrote substantial portions of the various reports filed by the Examiner.

16. On or about October 1, 1989, there was an initial meeting of the Coopers engagement team, which consisted of David Carpenter, Knute Kurtz (a new partner working under Carpenter), and a number of managers, including William Galbally. At that meeting, Carpenter assigned various members of the team to work on and investigate specific issues concerning the Southmark bankruptcy. Mr. Galbally was assigned to investigate issues including but not limited to

possible claims that Southmark might have against Drexel arising, *inter alia*, out of Drexel's relationship as underwriter of bonds sold by Southmark and as broker of "high yield" bonds.

17. Between October 2, 1989 and approximately December 4, 1989, Mr. Galbally worked on the Drexel issue along with other litigation-related issues in the engagement. He viewed the Drexel issue as being very important and believed that Southmark had substantial claims against Drexel in connection with Drexel's activities, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark. Mr. Galbally told Mr. Kurtz, among others, about the potential significance of the claims against Drexel.

18. On or about the night of December 4, 1989, Mr. Carpenter and Mr. Kurtz visited Mr. Galbally at his apartment in Dallas to discuss Southmark's potential claims against Drexel. After Mr. Galbally explained that he believed claims against Drexel might be Southmark's most significant claims, he was told to leave Drexel alone because Drexel was a significant audit client of Coopers. Mr. Galbally persisted that the Drexel issues had to be investigated and presented a Wall Street Journal article dealing with Drexel's role in Southmark's demise. Mr. Carpenter then told Mr. Galbally that he was being taken off the issues related to Drexel. Mr. Galbally was subsequently sent to Atlanta to work on preference actions under David Kennedy, which was essentially a demotion since Mr. Kennedy was Mr. Galbally's junior at Coopers.

19. On or about January 3, 1990, the potential claims against Drexel were reassigned to another Coopers' employee. Although further time was

billed to the Drexel investigation, no good faith attempt was made to develop the claims identified by Mr. Galbally.

20. On February 13, 1990, Drexel's parent, Drexel Burnham Lambert Group, filed for bankruptcy under Chapter 11. November 15, 1990 was set as the bar date for the assertion of pre-petition claims against Drexel.

21. On March 1, 1990, John C. Weitnauer of Alston & Bird, counsel for the Examiner, wrote to R. Paul Wickes of the Thompson & Knight firm to explain that Southmark might wish to pursue certain claims against Drexel in connection with the Examiner's review of potential preferential transfers, of which Drexel may have received $985,000 or more. Mr. Weitnauer's letter did not, however, mention any potential claims that Southmark might have against Drexel arising out of Drexel's activities investigated by Mr. Galbally, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

22. On April 17, 1990, Neal Batson, the Southmark Examiner, sent a letter to Mr. Wickes of Thompson & Knight (with copies to David Carpenter and Knute Kurtz) advising Thompson & Knight to pursue a "potential voidable preference paid to Drexel Burnham Lambert Incorporated . . . within the ninety-day period prior to Southmark's Chapter 11 filing on July 14, 1989." In this letter, the Examiner specifically states that he and his experts "have not attempted to investigate" any "securities claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel." The Examiner also stated that "[i]n light of the plan requirement that the Examiner file his final report

by conclusion of the hearings on confirmation and the recent bankruptcy of the parent, we are not inclined to devote additional resources to a further investigation of any potential Southmark claims against Drexel." At the time the April 17, 1990 letter was written and at all pertinent times thereafter, the Examiner was unaware of the work performed and theories developed by Mr. Galbally, unaware of the circumstances surrounding his removal from the Drexel examination, and unaware of Coopers' decision not to develop and assert claims against Drexel.

23. At no time during the course of Coopers' engagement on the Southmark bankruptcy did Coopers inform the Examiner, counsel for Southmark, or Southmark itself that Coopers was holding back from a full investigation of potential claims that Southmark might have against Drexel.

24. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers inform the examiner, counsel for Southmark, or Southmark itself that the Coopers employee originally charged with investigating the Drexel claims believed, contrary to the Reports prepared for the Examiner, that Southmark had substantial claims against Drexel arising out of Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

25. The bar date for filing pre-petition claims in the Drexel bankruptcy was November 15, 1990. Southmark's plan of reorganization (the "Plan") was confirmed on July 23, 1990 and Southmark emerged from chapter 11 in August 1990. At that point, Southmark had limited cash due in no small part to its payment of professional fees during the

bankruptcy, including more than $4 million paid to Coopers to investigate claims against, among others, Drexel. Southmark nevertheless was faced with having to make an immediate decision on whether to commission outside counsel to investigate claims against Drexel in advance of the November 15, 1990 bar date. Southmark knew nothing of Mr. Galbally's theories, and enthusiasm for pursuit of claims against Drexel. Southmark knew nothing of Coopers' predisposition to not seriously further investigate such claims. Southmark did know that Coopers had reported that proving claims against Drexel was "made difficult by the facts." Southmark believed that the downplaying of the Drexel claims at the same time Coopers was devoting substantial resources to far smaller claims was a reflection of Coopers belief that claims against Drexel relating to the issuance of junk bonds were not likely to be meritorious or to lead to a substantial recovery. As a result, Southmark did not further examine potential claims against Drexel, and did not file a proof of claim in the Drexel bankruptcy.

26. In early 1991, after the bar date for filing claims against Drexel has passed, Southmark investigated claims that could be asserted against Michael Milken, individually. That investigation revealed the existence of claims substantially similar to the claims Mr. Galbally had wanted to pursue but had been kept secret by Coopers.

27. As a result of the 1991 investigation, Southmark filed suit against Michael Milken and others in July 1991. As part of his settlement with the U.S. government, Mr. Milken has established a fund to cover claims asserted against him arising out of his junk bond activities. Southmark has reached

an agreement to resolve the Milken litigation pursuant to which Southmark is expected to recover in excess of $25 million out of the Milken settlement fund. A similar fund was created to fund claims asserted against Drexel in its bankruptcy proceeding. Southmark could have realized a substantially similar recovery from the Drexel fund had it known of the viability of its claims and timely filed a claim in the Drexel bankruptcy. Southmark did not know of the discovery of its claims because Coopers kept such information secret.

28. Southmark learned of Cooper's duplicity on April 8, 1993, when its General Counsel was told by William Galbally of the results of his investigation and his removal from the assignment because of Cooper's audit relationship with Drexel. Southmark thereafter filed a motion in the bankruptcy court seeking reconsideration of the fees Coopers received from its Southmark engagement. On February 27, 1995, the bankruptcy court issued its Memorandum Opinion and Order in which it was determined that Coopers was required to disgorge a substantial portion of the compensation paid to it from the engagement, plus Southmark's fees and expenses in prosecuting the motion for reconsideration in the bankruptcy court.

29. All conditions precedent to Southmark's rights to recover on each of its separate causes of action have been performed or have occurred.

IV. CAUSES OF ACTION

A. Count One - Breach of Contract

30. The applicable statutes of limitation do not bar any of Southmark's claims insofar as Coopers actively and continually concealed the facts giving rise to Southmark's claims through misrepresentations,

omissions and deceit; Southmark did not discover nor, in the exercise of reasonable diligence, could it have discovered the facts giving rise to Southmark's claims before the applicable limitation periods commenced dating back from the filing of this action; and the applicable limitation periods were tolled and have not ended. Accordingly, Southmark's claims are timely filed.

31. Although a by-product of the bankruptcy process, Coopers agreed to investigate third party claims held by Southmark, including claims held by Southmark against Drexel, and Southmark agreed to pay for such investigation. Southmark paid Coopers over $4 million pursuant to this agreement, fully performing its obligations.

32. Coopers breached its contract with Southmark by failing to fully investigate claims against Drexel, and, indeed, by stonewalling efforts by one of Defendant's employees to investigate claims against Drexel.

33. The breach of contract alleged herein proximately caused damage to Southmark.

34. On the basis of this cause of action, Southmark is entitled to recover actual damages, attorneys' fees, pre-judgment interest, post-judgment interest, and cots of court.

B. Count Two - Fraud and Deceit

35. Coopers engaged in common law fraud by (a) employing devices, schemes, conspiracies and artifices to defraud, (b) making untrue statements of material facts or omitting to state material facts necessary to make the statements made in light of the circumstances under which they were made, not misleading, and (c) engaging in acts, practices and a

course of business which operated as a fraud or deceit upon Southmark. Coopers made false representations of material fact to Southmark, which it either knew to be false or as to which it was reckless as to the truth of the representations. In addition, Coopers failed to disclose material facts to Southmark regarding its relationship with Drexel and its subversion of the Examiner's investigation of claims against Drexel. Coopers intended for Southmark to rely on its representations, and knew its misrepresentations and omissions of material fact would be misleading to Southmark. Southmark relied on these representations.

36. Among other things, Coopers represented to Southmark that the reason Coopers did not develop claims against Drexel was because of lack of time, lack of corroborative evidence, and the fact that Drexel had filed for bankruptcy. In fact, however, Coopers never intended to investigate claims against Drexel, its largest audit client, and it deliberately suppressed evidence concerning such claims developed by one of its managers.

37. Cooper's fraud proximately caused damage to Southmark. It was committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Southmark is therefore entitled to an award of exemplary damages, in addition to its actual damages, in an amount to be determined by the jury commensurate with the facts of this case and in accordance with the law.

C. Count Three - Breach of Fiduciary Duty

38. Alternatively, as a result of its appointment to investigate claims on behalf of Southmark, and the relationship of trust and confidence created thereby,

Coopers had a fiduciary relationship with Southmark and owed it fiduciary duties, including duties of care, good faith and loyalty.

39. Coopers violated its fiduciary duties to Southmark, including, but not limited to the duties of care, good faith and loyalty. Coopers also engaged in unconscionable conduct towards Southmark by, among other things, subverting the investigation of claims against Drexel in the interest of Drexel and contrary to the interest of Southmark.

40. The breaches of fiduciary duty by Coopers proximately caused damage to Southmark. The breaches of fiduciary duty were committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Therefore, Southmark is entitled to an award of exemplary damages, in addition to its actual damages, in an amount to be determined by the jury commensurate with the facts of this case.

D. Count Four - Negligent Misrepresentation

41. Pleading further in the alternative, Coopers made false representations for the guidance of Southmark in its business. In the course of its business and in a transaction in which it had a pecuniary interest, Coopers did not exercise reasonable care or competence in obtaining the information on which those representations were based and in communicating that information, and Southmark suffered pecuniary loss by justifiably relying on the representations. Coopers' negligent misrepresentations alleged herein proximately caused damage to Southmark and were committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Therefore, Southmark is entitled to an award of

exemplary damages, in addition to actual damages, in an amount to be determined by the jury commensurate with the facts of this case.

V. DAMAGES

A. Actual (Direct and Consequential) Damages

42. Coopers' acts and practices described above have caused, and continue to cause, Southmark to suffer substantial actual damages to its business, both direct and consequential. Coopers is therefore liable for its wrongful conduct in an amount far in excess of the minimal jurisdictional limits of this court.

B. Exemplary Damages

43. Because Coopers' conduct constitutes fraud and misrepresentation, and because Coopers has acted with malice or with heedless disregard for Southmark's rights, Coopers is liable for substantial exemplary damages.

C. Attorneys' Fees

44. Southmark is entitled to its reasonable attorneys' fees pursuant to Tex. Civ. Prac. & Rem. Code § 38.001.

D. Interest

45. Southmark is entitled to compound pre-judgment interest at the rate set by Tex. Rev. Civ. Stat. Ann. art. 5069-1.05.

46. Southmark is entitled to post-judgment interest at the maximum rate permitted by law.

WHEREFORE, Plaintiff Southmark prays for judgment against Defendant Coopers, finding it liable to Southmark, and praying specifically that it have:

1. a trial by jury;
2. all of Southmark's actual damages;
3. exemplary damages in an amount which Southmark may show to be appropriate;
4. pre-judgment interest and post-judgment interest at the maximum rate(s) permitted by law or equity;
5. reasonable attorneys' fees and costs; and
6. such other and further relief as to which Southmark may show itself to be justly entitled.

Respectfully submitted,

McKOOL SMITH, P.C.

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THE CONSTITUTION OF THE UNITED STATES OF AMERICA

ARTICLE III

Section 1. The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish. The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office.

UNITED STATES CODE

28 U.S.C. § 1334(c)(2)

Upon timely motion of a party in a proceeding based upon a State law claim or State law cause of action, related to a case under title 11 but not arising under title 11 or arising in a case under title 11, with respect to which an action could not have been commenced in a court of the United States absent jurisdiction under this section, the district court shall abstain from hearing such proceeding if an action is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction.

28 U.S.C. § 157

§ 157. Procedures

(a) Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.

(b) (1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title.

(2) Core proceedings include, but are not limited to--

(A) matters concerning the administration of the estate;

(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for

the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;

(C) counterclaims by the estate against persons filing claims against the estate;

(D) orders in respect to obtaining credit;

(E) orders to turn over property of the estate;

(F) proceedings to determine, avoid, or recover preferences;

(G) motions to terminate, annul, or modify the automatic stay;

(H) proceedings to determine, avoid, or recover fraudulent conveyances;

(I) determinations as to the dischargeability of particular debts;

(J) objections to discharges;

(K) determinations of the validity, extent, or priority of liens;

(L) confirmations of plans;

(M) orders approving the use or lease of property, including the use of cash collateral;

(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and

(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity

security holder relationship, except personal injury tort or wrongful death claims.

(3) The bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11. A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law.

(4) Non-core proceedings under section 157(b)(2)(B) of title 28, United States Code, shall not be subject to the mandatory abstention provisions of section 1334(c)(2).

(5) The district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending, or in the district court in the district in which the claim arose, as determined by the district court in which the bankruptcy case is pending.

(c) (1) A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.

(2) Notwithstanding the provisions of paragraph (1) of this subsection, the district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to

a bankruptcy judge to hear and determine and to enter appropriate orders and judgments, subject to review under section 158 of this title.

(d) The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.

(e) If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.